
FRBSF WEEKLY LETTER

December 29, 1989

Do Banks Need Securities Powers?

In the United States, interactions between commercial banks and U.S. businesses are severely restricted. Banks can make loans to businesses and purchase investment-grade corporate debt, but banks are not allowed to hold either corporate equity or below-investment-grade debt. The investment banking restrictions imposed by the Glass-Steagall Act, moreover, limit the ability of commercial banks to underwrite and market the securities of U.S. corporations, and limit the types of securities that banks themselves may issue.

These restrictions frequently are blamed for the dramatic decline in the prominence of U.S. commercial banks in world financial markets. Whereas U.S. banks had over 30 percent of total world banking assets in 1970, they have less than 10 percent today. Similarly, no U.S. bank currently is among the world's top 20 banks. Foreign banks, in contrast, have broader powers, which, some argue, have enabled them to grow through profitable diversification of their holdings and activities in the securities area. Many worry that U.S. banks' ability to compete will deteriorate further if the European banks adopt, as planned, the universal banking model in 1992.

A number of issues must be resolved before bank powers can be expanded, including concerns over propagation of the banking safety net. This *Letter*, however, argues that more is at stake in the expansion of commercial banking into the securities area than the simple diversification advantages often claimed for expansion of powers. Without the ability to underwrite, hold, and create a variety of securities, U.S. commercial banks will become increasingly handicapped at providing even their primary financial service, loans to commercial enterprises. In addition, contrary to the conventional view, expanded powers actually may improve the self-discipline of the banking system against risk taking.

A strong affinity

Historically, investment banking and commercial banking have tended to be integrated. In the United States, commercial banks were providing investment banking services as early as 1812, and continued to do so until prohibited by the

Comptroller of the Currency in the 1890s. They began providing such services again through affiliates, and by 1927, were the dominant providers, performing over 60 percent of all corporate bond underwriting. When the banking affiliates were disbanded by law in 1933 and replaced by independent investment houses, total capital in the U.S. investment banking business fell by two-thirds. This suggests that the market believed that independent investment banks were likely to be less effective than those affiliated with banks.

Indeed, in countries outside the U.S. where integration has been permitted, banks are the dominant investment bankers. In the "universal banking" systems of Germany, Switzerland, and Austria, for example, there is virtually no separation of commercial and investment banking, and banks hold, underwrite, and broker corporate securities. The European Community has identified the universal banking system as the model for the EC when Community-wide banking is permitted in 1992.

In Japan, there is greater legal separation of banking and securities powers than in the true, universal banking countries; Japanese banks may not underwrite securities, for example. Cross-shareholding among banks, insurance companies and securities houses, however, creates a high level of *de facto* integration of banking, investment banking, and commerce. Virtually all of the top securities firms and insurance companies are associated with a "main" bank in these so-called "keiretsu" groupings.

In addition, banks may hold significant equity interests in industrial firms. At present, banks may hold directly up to five percent of their assets in the equity of industrial corporations (10 percent, before 1987), and more through their affiliated insurance companies. Banks and their affiliated insurance companies hold roughly 30 percent of all corporate equity in Japan.

What do investment bankers do?

To understand why banks with broad securities powers are dominant (where they are permitted), it is necessary to understand the economic

FRBSF

purpose served by the underwriting process, and the purpose served by bank ownership of corporate equity.

The underwriting function is the major function of an investment bank. When a corporation seeks to sell securities to investors, it must overcome certain "information asymmetries" that exist in the marketplace. In particular, the corporation seeking funds has better information regarding its future prospects than do investors, and investors may fear that the reported prospects are overstated. For this reason, without reliable, additional information to the contrary, the market may value the corporation's securities at a level below their true value, to the detriment of the corporation's funding efforts.

Since investors generally cannot afford to develop their own information channels, a third party—an investment bank—frequently is called upon to help bring the sellers and buyers of the securities together. To resolve the information asymmetry, the investment banker must obtain information of nearly the same quality as that held by the corporation itself. It obtains this information through independent research and investigations of the financial condition of the firm, and by exploiting the close relationship it often has as the firm's prior underwriter and even shareholder or director.

Once it has obtained the necessary information, the investment banker must persuade investors of the quality of this information if the information asymmetry is to be overcome. Investment bankers gain investor confidence essentially by developing a reputation for accurate representation. The investment banker's reputation thus is extremely important in the underwriting process; reputation even determines the order in which the participating investment banks are named in the newspaper "tombstone" announcements of new underwritings. Since investment banks put this valuable "reputational capital" at risk whenever they underwrite a new security, the incentive to misrepresent the issuing firm's prospects and thereby exploit investors is diminished.

Benefits of integration

Investment bankers' ability to resolve information asymmetries is not perfect. Indeed, the most information-sensitive issues, initial public offerings, still sell when issued at prices significantly below

their ultimate market price. Nonetheless, resolution of information asymmetries is at the heart of investment banking. It also provides possible explanations for the apparent dominance of universal banks over single-function commercial and investment banks.

First, there may be economies in the joint provision of investment and commercial banking services. Specifically, the skills investment banks require to underwrite and market corporate securities are analogous to those needed to evaluate, monitor, and market bank assets and liabilities. As a result, an organization that combines both functions may be able to do so more cheaply than can two stand-alone organizations.

A second, and possibly more important, reason for the dominance of the universal form of banking is that such an arrangement may enhance banks' ability to monitor and manage the risks associated with their lending activity, thereby improving the risk-adjusted return enjoyed by banks. Conventionally, a commercial bank's means of controlling adverse behavior are limited to invoking loan covenants and withdrawing loan funding. The underwriting relationship available to a universal bank enhances this channel of influence, since a corporation that performs badly on its loans is at risk also of losing access to reputable underwriting and, hence, to other economical sources of funds.

Likewise, a universal bank's ability to own the equity of the borrowing firm permits the lender to participate in the firm's management, thereby directly influencing the decisions to take on risks. In essence, holding some of the equity helps resolve the incentive borrowers always have to take advantage of lenders by taking on riskier projects than the lender had anticipated.

Interestingly, this combined shareholder/lender role played by universal banks is precisely analogous to the "stapled" debt and equity financing ("strip" financing) employed in some takeover restructurings in the U.S. industrial sector. Financial economist Michael Jensen has argued that such combined positions in both debt and equity improve corporate control and, thereby, corporate efficiency. U.S. bank regulation, however, restricts such multi-security investments by banks.

The evidence

Contrary to the views of some proponents of expanded securities powers, therefore, the advantages of blending investment and commercial banking may *not* come from enhanced opportunities for diversification. Indeed, evidence suggests that diversification alone cannot explain why universal banking dominates single-function banking. Economists at the Federal Reserve Bank of Minneapolis have looked for advantages arising from diversification by studying the covariance of returns to banking and non-banking activities. They found few benefits from diversification. In any event, the benefits of diversification should be available to investors simply by owning equity in both commercial and investment banks; a physical joining of these enterprises is not necessary.

There is, however, anecdotal evidence that equity holdings and/or underwriting relationships offer the advantages in information or incentives control hypothesized earlier. In both Germany and Japan, for example, banks are permitted to hold corporate equity and establish close working ties to nonbank business. Businesses in both countries obtain more of their financing from banks (and less from direct placement markets) than in the United States. In Germany and Japan, about 75 and 80 percent, respectively, of corporate financing comes from banks, versus 40 percent in the United States. Although this may be partly a result of constraints on the primary securities markets in Germany and Japan, the pattern also is consistent with the argument that a more effective monitoring process stimulates bank lending.

In both Germany and Japan, economic historians attribute the rapid pace of economic development partly to the close financial relationships between industrial and financial firms. In Germany, these relationships took their current form in the late 1800s and, it is believed, contributed to the rapid economic development that subsequently occurred.

In Japan, there is a similar association in time between economic performance and broad bank securities powers. Fifty years ago, Japanese corporations obtained only about five percent of their financing from bank loans, and as recently as 1950, financial corporations owned less than 10 percent of corporate equity. Japan's rapid

economic development since that time has coincided with increased bank participation in finance.

The variations in finance patterns across Japanese firms today also are consistent with the notion that expanded financial powers facilitate bank lending activity. The Japanese firms with the strongest equity links (members of the "keiretsu" industrial groups) rely on bank lending to a greater degree than other firms. In fact, they employ debt-finance overall to a greater degree; keiretsu members have a debt-to-equity ratio that is 50 percent higher than non-member firms. This suggests that bank relationship in Japan may help to resolve the information-asymmetry and incentive-control problems generally associated with debt finance.

More stability?

Broadening the securities powers of banks also may enhance the stability of the economy. Economists Hoshi, Kashyap, and Scharfstein, for example, find that the firms associated with keiretsu in Japan tend to alter their investment in plant and equipment less abruptly in response to changes in cash flow than do other firms. To the extent that such effects result in less volatile investment in the aggregate, the attendant changes in business activity may be less exaggerated.

We have not discussed the complex issues of the bank safety net and deposit insurance which, in the U.S., are important considerations of bank powers reform. It is possible, however, that integration of securities powers into banking could actually reduce potential claims on deposit insurance. One channel of such influence would be via the improved loan monitoring that expanded securities powers would permit. In addition, however, maintaining a high level of reputational capital is critical to effective investment banking. Such reputational capital can be viewed as a goodwill "asset" of a universal bank that would be lost or diminished if the banking firm were perceived to be engaging in overly risky behavior. This may provide an important, internal discipline against risk-taking.

Randall J. Pozdena
Vice President

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Barbara Bennett) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120